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773–387—65

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 1053

DONALD D. RANDALL AND JEAN E. RANDALL, ESTHER FENDER, JEAN E. RANDALL, DONALD D. RANDALL, C. LEO FENDER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 1–36) are not officially reported. The opinion of the court of appeals (Pet. App. 37–59) is reported at 338 F. 2d 924. The order of the court of appeals denying a petition for rehearing is not officially reported.

JURISDICTION

The judgments of the court of appeals were entered on December 1, 1964.[1] A petition for rehearing was filed on December 30, 1964, and denied on January 14, 1965. The petition for a writ of certiorari was filed on April 12, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court of appeals was correct in holding that taxpayers Fender and Randall, the sole and equal stockholders of Fender Sales, Incorporated, realized taxable income when prior years' salaries owed them by the corporation were paid and the liability discharged by the issuance to taxpayers of additional common stock of the corporation.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

> SEC. 61. GROSS INCOME DEFINED.
>
> (a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> (1) Compensation for services, including fees, commissions, and similar items;
>
> * * * * *

[1] Five identical judgments were entered on December 1, 1964, by the court of appeals reversing the Tax Court as to these petitioners. Petitioners have not printed these judgments in the appendix to their petition; one representative judgment is printed as an appendix herein, *infra*, p. 11.

(12) Income from discharge of indebtedness;

* * * * *

[26 U.S.C., 1958 ed., Sec. 61.]

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.61–1 *Gross income.*

(a) *General definition.* Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. * * *

* * * * *

[26 C.F.R. 1.61–1.]

SEC. 1.61–2 *Compensation for services, including fees, commissions, and similar items.*

* * * * *

(d) *Compensation paid other than in cash*— (1) *In general.* If services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. * * *

* * * * *

(4) *Stock and notes transferred to employee* * * *. * * * if a corporation transfers its own stock to an employee * * * as compensation for services, the fair market value of the stock

at the time of transfer shall be included in the gross income of the employee * * *.

* * * * *

[26 C.F.R. 1.61–2.]

STATEMENT

Fender and Randall[2] owned all of the common stock (the only type of stock issued) of Fender Sales, Incorporated; they each owned 50 shares, with a par value of $100 per share. Fender and Randall were employed as officers of Fender Sales, at annual salaries of $15,000. (Pet. App. 38.)

Fender Sales reported income on the accrual method of accounting for federal tax purposes. It accrued and deducted the salaries of Fender and Randall each year for its fiscal years 1954, 1955, 1956, and 1957 (a total of $60,000 salary for each man) but did not pay these salaries to Fender and Randall. Fender and Randall, on the cash basis of accounting for federal tax purposes, did not report these salaries as income for 1954, 1955, 1956, and 1957 on their federal tax returns. (Pet. App. 39–41.)

To comply with the request of the corporation's lender-bank that the salary liability to Fender and Randall be capitalized so as not to be prior to the bank's claims for loans, Fender and Randall, after the close of the corporation's tax years 1954–1957,

[2] Donald D. Randall and C. Leo Fender are the parties in interest; the two other petitioners are their wives. The cases of the petitioners were consolidated in the Tax Court and in the court of appeals with that of Fender Sales, Incorporated; all arose out of one set of facts. The Commissioner has filed a conditional cross-petition from the judgment of the court of appeals as to Fender Sales, Incorporated (No. 1118). See pp. 5–6, *infra*.

offered to accept one share of $100 par value common stock of Fender Sales for each $100 of salary owed them. The offer was accepted by Fender Sales and the stock issued (600 shares to each man). As a result, Fender Sales' capital stock account was increased by $120,000 and the $120,000 salary liability was discharged and cancelled. (Pet. App. 38–40.)

The Commissioner of Internal Revenue asserted tax deficiencies against Fender and Randall, and, alternatively, against Fender Sales. The Commissioner took the position that the receipt of the stock by Fender and Randall constituted taxable salary income to them, but that, if it did not, then Fender Sales realized taxable income as a result of the cancellation of the salary indebtedness. The Tax Court (Pet. App. 1–36) held that neither Fender and Randall nor Fender Sales realized income in the transaction. The Commissioner appealed to the Court of Appeals for the Ninth Circuit, contending that Fender and Randall had realized income, but, if not (and only if not), then Fender Sales had. The court of appeals (Pet. App. 37–50), Judge Barnes dissenting (Pet. App. 50–59), agreed that Fender and Randall had realized income in the transaction, and reversed the Tax Court as to them. The court of appeals correspondingly held that Fender Sales had not realized any income and dismissed the Commissioner's petition for review as to it. (While opposing this petition by Fender and Randall, the Commissioner has filed a cross-petition (No. 1118) from the court of appeals judgment in

favor of Fender Sales, which the Commissioner requests be granted in the event the present petition is granted.)

ARGUMENT

The decision below is correct, there is no conflict, and the issue presented turns on the particular and unusual circumstances of this case. There is therefore no occasion for review by this Court.

1. Fender and Randall received common stock of Fender Sales in payment of the corporation's fixed salary debt to them, accrued and deducted by the corporation in prior years. The applicable law (Section 61(a)(1) of the Internal Revenue Code of 1954, *supra*, pp. 2–3) taxes "all income from whatever source derived." The applicable Regulations provide that "* * * if a corporation transfers its own stock to an employee * * * as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee." (Treasury Regulations on Income Tax (1954 Code) 1.61–2(d)(4), *supra*, pp. 3–4.) The court of appeals pointed out (Pet. App. 41) that it "is implicit in the foregoing fact statement and is conceded by respondents [the petitioners here] that the shares of Fender Sales, Inc., issued to each of the shareholders, Fender and Randall, had a fair market value of $100 per share (par value)." The court of appeals also noted (Pet. App. 43), citing the pertinent Regulation, that "the additional stock issued is, in any event, presumptively equal in value to the liquidated obligations

discharged."[3] Under ordinary principles, therefore, the receipt of the stock by Fender and Randall in satisfaction of the corporation's previously deducted salary obligation to them would constitute taxable income to each man of $60,000.

Petitioners contend, however, that a different result should obtain here because of the unusual circumstance that Fender and Randall were sole and equal shareholders of the corporation before the issuance of stock in payment of their salaries and, having received equal amounts of stock for equal salary claims, they remained sole and equal shareholders after the transaction. Petitioners rely upon *Eisner* v. *Macomber,* 252 U.S. 189, which involved a stock dividend paid to shareholders in proportion to their existing stock holdings and which held that the stock dividend was not income because there had been no change in either the corporation's net worth or in the shareholders' interests. Petitioners claim that their receipt of additional common stock similarly left them and the corporation in exactly the position they were in before the transaction. This contention, however, ignores the fact that, in consideration for petitioners' receipt

[3] Treasury Regulation on Income Tax (1954 Code), Sec. 1.61–2(d)(1),(*supra*, p. 3) provides, in pertinent part:

"If services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary."

There was no such evidence to the contrary presented in this case.

of the additional stock, the corporation's previously deducted salary liability to them was discharged. Thus the positions of both the petitioners and the corporation were changed: Fender and Randall had their claim for compensation for past services satisfied by the issuance of the stock and, in consequence, the corporation's net worth increased by $120,000, the value of the satisfied claims. In essence, therefore, Fender and Randall exchanged their existing salary claims for stock. As the court of appeals held (Pet. 48), this disposition of their fixed right to receive income was a taxable event. See *Helvering* v. *Horst*, 311 U.S. 112.

Fender and Randall can avoid tax liability here only if they are treated, not as having used the corporation's outstanding debt to them to buy its stock, but as having merely originally contributed their services to the corporation. This view ignores the fact that the corporation actually owed salary debts to Fender and Randall and that it had already taken deductions for these salaries in earlier years—deductions to which the corporation would not have been entitled had taxpayers actually been contributing their services.[4] The decision of the court of appeals not to treat the transaction retroactively as a contribution of

[4] Thus, as we show in our conditional cross-petition in No. 1118, if Fender and Randall are not deemed to have used their salary claims against the corporation to buy stock, but merely to have contributed services, the amount of their discharged salary claims would necessarily have to be taken into income by the corporation, since the corporation would then have taken salary expense deductions from income which it had never paid and would never pay.

services to the corporation was therefore clearly reasonable and, in light of the unusual facts of the case, calls for no further review.

2. There is no conflict. We have already shown that *Eisner* v. *Macomber, supra,* dealt with a different situation. Petitioners also allege a conflict between this case and *Lidgerwood Manufacturing Co.* v. *Commissioner,* 229 F. 2d 241 (C.A. 2), certiorari denied, 351 U.S. 951, and *Bratton* v. *Commissioner,* 217 F. 2d 486 (C.A. 6), two cases dealing with the right to take a bad debt deduction, a situation raising different considerations. In any event, no inferences which can be drawn from *Lidgerwood* and *Bratton* conflict with the present result. In *Lidgerwood* a parent corporation cancelled its subsidiary's debts to it and took common stock in return. The parent then claimed a bad debt loss on the debts, alleging that the issuance of the stock was meaningless because the debts were uncollectible. No loss was allowable, the court holding that the taxpayer had made a capital contribution. Thus the parent was treated as having exchanged the debts for stock, not as having failed to collect the debts, just as in this case the court of appeals treated Fender and Randall as having exchanged their salary claims for stock, not as having failed to collect their claims. As the court of appeals in this case stated (Pet. App. 44), *Lidgerwood* thus supports the result reached below, since in *Lidgerwood* the court "rejected the taxpayer's contention that nothing had been received by virtue of the issuance of the additional stock * * *." In *Bratton* an individual shareowner

paid some of his corporation's debts and released the corporation from the obligation to reimburse him. A bad debt deduction was disallowed on the ground that the taxpayer had made a capital contribution to the corporation. Thus the court did not hold, as petitioners urge here, that the taxpayer failed to collect a pre-existing debt owed to him by the corporation.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General.
MELVA M. GRANEY,
DAVID I. GRANGER.
Attorneys.

MAY 1965.

APPENDIX

United States Court of Appeals
for the Ninth Circuit

No. 19,075

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

vs.

DONALD D. AND JEAN RANDALL, RESPONDENTS.

JUDGMENT

Upon Petition to Review a Decision of the Tax Court of the United States,

This Cause came on to be heard on the Transcript of the Record from the Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is reversed.

Filed and entered December 1, 1964.

U.S. GOVERNMENT PRINTING OFFICE: 1965